PROPERTY INSURANCE REPORT

The Authority on Insuring Homes and Commercial Property

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GOP Reformer Unseats North Carolina Regulator

Republican **Mike Causey** narrowly defeated Democrat **Wayne Goodwin**, the **North Carolina** insurance commissioner since 2009. Causey, an insurance agent, promised to reform the state's outdated rate bureau system. In **Montana**, Republican state Sen. **Matthew Rosendale** defeated Commissioner **Monica Lindeen's** chief counsel. Republican **Jon Godfread** will succeed **North Dakota** Commissioner **Adam Hamm**, who did not run. Democrat **Trinidad Navarro** won in **Delaware.** She beat Commissioner **Karen Weldin Stewart** in the primary.**Washington** Commissioner **Mike Kreidler,** a Democrat, won a fifth term. PIR

Hot Property Insurance Trends To Watch for in 2017 and Beyond

At the end of our national conference this month, Property Insurance Report *Editor Brian Sullivan offered his annual list of trends to watch for as we enter the new year. Below we touch on the major topics, though it is not a complete summary of the discussions. For that, you have to have been there.*

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HOMP Policy Count Will Continue to Lag

While growth in homeowners multiperil direct premium written has been worth celebrating – a 43.2% increase over the decade ending 2015 – it is important to remember that almost all the growth is coming from rate increases and increases in replacement costs rather than unit growth.

In 2013, the last full year of policy count data from the **National Association of Insurance Commissioners**, insurers wrote 50.2 million HO3 policies in the United States. That was down from 50.7 million in 2012, 51.3 million in 2013 and the all-time peak of 51.7 million in 2008. Policy count was up just 5% for the decade ended 2013, a period in which premium grew 55.3%, more than 10 times faster.

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Why is this happening? More people are living in rentals and condominiums. We're not suggesting that the suburbs are going to be drained, but at the margin, today's society is tipping toward different kinds housing.

This is not the existential crisis that auto insurance faces with autonomous cars. We believe there will be a rebalancing at some point, as a growing population looks again toward single-family homes. But this current trend toward more shared living feels like it can last for at least another five years.

The stagnation in policy growth is a bigger problem for challengers than incumbents. When people move, or pur-

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chase a new home, they will consider a spectrum of home insurers to meet their new need. The loss of this movement is bad news for insurers that are determined to grow but struggle to dislodge customers with existing coverage. The absence of policy growth isn't exactly good news for the entrenched insurers, but at least it does not hurt as much.

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Private Flood Insurance Has a Chance

Before the election, we were not optimistic about the prospects for market-based pricing for flood insurance. With **Hillary Clinton** predicted to be the next president, few believed it would be possible to push through actuarially sound rates

> ***The painful experience of the last attempt to reform flood insurance could prove useful this time around.***

that would have hurt low-income people living in flood plains as much as wealthy residents of coastal communities. But with a government run by the Republican Party, there is a better chance that enormous government subsidies – some might say they're "huge" – won't be welcome. The willingness of insurers and reinsurers to engage in the flood business could also be an enticement for change, given Republican desires for privatization of government programs.

The pending expiration of the **National Flood Insurance Program** in September 2017 will force the discussion. Also, with President-elect **Donald Trump** promising big infrastructure investments, there is a chance that a new strategy for the flood program could be tied to big spending on flood mitigation projects.

Before you get too excited, allow us to pour cold water on excessive dreams of flood insurance opportunities. For a new president struggling to manage in a hostile environment, adopting risk-based pricing for flood insurance may be more trouble than it is worth. Would you stick your head in that hornet's nest? What's more, we fell in love with the virtues of risk-based pricing outlined in the 2012 Biggert-Waters reform legislation, but we were proven wrong when the public, and politicians, were shocked by the extent of the problems. We're more cautious this time, but we think it wise to keep an eye open for change given the more hospitable environment.

The Biggert-Waters blowback will help inform any new reforms. It never made any sense to move to actuarially sound rates in a hurry, something we pointed out at the time. A better approach is to establish the true risk-based rate, state it clearly, and then set a course to get there over a 10-year period. That way the real estate market can slowly adapt to the new reality for existing structures, and new developments in high-risk areas will be started – or not – based on real-world economics. We're not confident Washington is smart enough to take this necessary gradualist approach, but we are confident that gradualism is the only way it can work.

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Insurers Never Get to Have Fun: Drones Will be Flown by Others

The **Federal Aviation Administration** has shown a surprising level of support for the use of unmanned aerial vehicles, better known as drones, and insurers have moved rapidly to deploy them. Following Hurricane Matthew, a number of insurers surveyed properties with drone flights in a way that was more effective (better photography), more safe (no one up on a wet and/or damaged roof) and less expensive than sending someone up on a ladder.

So how will these drones be deployed? Early on, there were discussions of current adjusters gaining the skills necessary to fly drones, augmenting their current tasks. The idea was simple: replace the ladder with the drone in the adjuster's tool kit. Adding support to this idea was the increasing technical capability of drones. Drones

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can be programmed to fly through a complex flight plan based on the GPS coordinates of a home's outline, identified from existing aerial imagery. The concept: the adjuster need not fly the drone. Rather, they just set it on the driveway and push "start" and the drone will do the rest.

We have firsthand experience with this advance. Flying the official *Property Insurance Report* drone (no joke), we spent hours perfecting the skill of circling a fixed point while keeping the drone a consistent distance away from an object and keeping the camera focused on the same place. In the newest release of our drone, the DJI Phantom, you set the item of interest in the system, and the drone will circle it automatically at a set distance. Someone picking up the controller for the first time can now perform an important function immediately and better than we could accomplish with hours of practice.

Alas, for all the advances in technology, we are likely still several years away from the kind of technical skills necessary to fly around a house automatically, avoiding branches, wires, downed trees, people walking by, birds flying by, etc. It will eventually be possible, but even the developers say truly autonomous flight is not in the near future. Thus the need for an operator with a degree of skill far greater than putting a ladder up to a roof and climbing.

As a side note, the idea of trading the ladder for a drone assumes all adjusters use ladders and climb roofs. In reality, climbing on a roof and navigating steep and slippery slopes requires considerable skill and experience, and in many if not most cases experts are called in to conduct roof inspections in the place of claims adjusters.

So how will this new tool be adopted? Will insurers own fleets of drones, to be used by adjusters trained in flight and augmented by specialists in the insurer's employ? For insurance executives thrilled at the chance to operate their own air force, this is not likely.

Maintaining a fleet of drones and their pilots requires a number of things that in most cases are more efficiently done by third parties.

The drones themselves become obsolete quickly. The $1,200 *Property Insurance Report* drone went from cutting edge to hopelessly obsolete (and discontinued) in less than 12 months. By all reports, this pace of change is not likely to slow any time soon.

Tools such as drones need to be constantly employed to make sense, and only the largest insurers could hope to have drone operations on a full-time basis.

Even when the tools become more mature, they're likely to make big leaps every 24 months, along the lines of smartphones today.

The pilots, too, present a problem. Flying a drone once a month or so is not optimal. (Trust us, we crashed enough to know). Once trained and licensed, pilots must work often to maximize their skill and continue to build their experience.

> ***The dream of fully autonomous drone flights – eliminating the need for a skilled pilot – is likely years away.***

Giant insurers might be able to make this work, along with a handful of regional insurers that have significant market share in their own states. **State Farm's** 20% share of the U.S. homeowners market might be enough scale. But beyond that, drone usage has the feel of a service that will be outsourced to specialists.

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The FAA's Fast Action on Quadcopters Opens Door for Fixed-Wing Drones

Almost all of the current discussions about drones center on "quadcopters," which are essentially small, camera-carrying helicopters with four or more rotors.

These devices are extraordinarily capable, delivering the highest quality images possible today. A person on the roof, or standing next to

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damaged siding, can't deliver better images.

But drones have drawbacks. The most significant is flight time. The very best quadcopters cannot fly for more than half an hour. Pilots quickly learn that 20 minutes is a wise limitation, preserving battery power for a guaranteed return flight. Fortunately, that is normally enough to capture all you need from a single property.

But what if you want to capture more than one property at a time? Quadcopters are simply not equipped for that task at this time. What can do the job? Fixed-wing drones. These are essentially small airplanes, with no pilot aboard, that can fly at a few hundred feet rather than a few thousand feet. They can stay aloft for hours at a time, capturing images of thousands of properties. The photos are not as good as those captured by a quadcopter flying 5 feet from a roof, but they are better than those that are captured by many fixed-wing manned aircraft and can be deployed more quickly and at a lower cost. (Even flying higher, the highly sophisticated cameras in some manned aircraft can outperform lower-flying fixed-wing drones.)

> ***It is helpful to have a workforce demographic that matches the customer demographic.***

The key to adoption of fixed-wing drones is the FAA. The government has already allowed some commercial testing of these tools, and there is reason to believe it might make the kind of quick leap toward acceptance that has been shown in the quadcopter rules.

As with all things related to the federal government, the recent changes bring with them a wildcard. It is possible the deregulation wing of the Republican Party could embrace a looser FAA approach. It is also possible that the privacy wing of the Republican Party could have a heart attack over the prospect of low-flying aircraft photographing their every move, and the FAA could be forced to retreat. We doubt anyone can say with confidence how this will play out.

If and when you can combine the close-in imagery of quality quadcopters with the low-flight capability of fixed-wing drones, the optimal aerial imagery package will be complete: 1) quadcopter drones; 2) fixed-wing drones; 3) fixed-wing manned aircraft; 4) satellites

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Insurers Have Structural Advantages In Building a Diverse Workforce

Assumption: It makes good business sense to build a diverse workforce that reasonably matches the population as a whole. Most white-collar industries such as insurance tend toward white and male employee populations, and this presents challenges in fully understanding and serving a more diverse set of customers. There is a secondary benefit to a more diverse workforce, in that it opens the door to smart people who get left out of a monoculture. More smart people equals more success.

And if those and other business reasons are not incentive enough to pursue a more diverse workforce, it helps simply knowing that it is the right thing to do.

Definition of terms: for our purposes, when we refer to individuals who would increase workforce "diversity" we are talking about anyone other than the European-descended white heterosexual males who are currently represented in the insurance industry beyond their percentage of both the overall population and the population of Americans with the skills necessary to work for insurance companies.

Most insurers certainly have a distinct disadvantage in fostering workforce diversity: geography. Companies such as **State Farm** are based in small cities that have a predominantly white, European population. Companies such as **Allstate** are right next door to hyper-diverse Chicago, but for many residents of that city, the company's offices in suburban Northbrook might as well be in

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Milwaukee. They either can't get there, or don't want to. **Nationwide** is in Columbus, **Ohio**. **Farmers** once benefitted from its Los Angeles location, but the move to a suburb (a decision we would have also made, given Farmer's choices) gives it nicer offices but Allstate's diversity challenge.

Though it isn't easy, the geography problems can be overcome. Allstate, for example, has opened downtown offices that give it access to a new pool of potential employees. All large insurers have field offices that can provide them with opportunities to attract a different employee population.

But we believe insurers have more advantages than disadvantages in building a diverse workforce.

For starters, insurers have a remarkably diverse set of tasks within the enterprise. This isn't like an engineering firm trying to broaden its employee base. It isn't as if insurers hire only actuaries or only sales people. Indeed, insurers offer just about any imaginable job, including not a small number of blue-collar positions. Bankers, often considered the closest organizational type to insurers, can't begin to compete for breadth of jobs. So while it might be hard to have tremendous diversity in one specific department, the enterprise should have no problem overall.

Insurers also have a remarkably well-defined set of tasks, with measurable performance metrics. This is important because one barrier to diversity is the challenge of one group of people understanding another. When you have less measurable performance metrics, managers assess the work of their employers based on how the feel they are performing. This is easier to do when you and the employee share a common background, world view and heritage. Thus, there is a tendency to hire a team that is in the mold of the manager. And given the current state of insurance industry leadership, that manager is most like to be a white heterosexual male of European descent. When performance is measured in a more empirical way, diversity is easier to achieve.

Along these lines, insurers are also thoroughly legalistic and bureaucratic, which means that once a policy is set, it tends to be followed. Cultural reluctance to change can hold back even the most well-meaning organization. But give an insurance organization a defined set of rules, and they are more likely to be followed than in other industries where the culture is less accustomed to such definition.

Speaking of something that is ill-defined, we submit that insurance company culture has another advantage. Insurance organizations most often have a culture of family, rather than the kind of warrior mentality that pervades investment banks or many retail organizations. In fact, a complaint lodged against insurers from outsiders who enter the industry is that the culture can be too "soft." There is validity to the observation of a "softer" culture, and in some cases it can be problematic. But in efforts toward greater diversity, this more family-style culture can be a clear advantage if the family is inclusive.

> ***Home-office geography is an undeniable challenge to insurers seeking to build diversity in their workforce.***

At the end of the day, the structural advantages insurers enjoy far outweigh the structural shortcomings. We have seen insurers make great strides toward diversity in the past decade. But more work is required to truly take advantage of the gains that come with an employee population that looks more like the customer population.

We were fortunate to have an excellent panel discussion on the topic of workforce diversity at the recent conference, and we will share more highlights of that discussion in a future issue.

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President Trump Likely Means More Conservative Courts

Like almost everyone, the presidential election results caught us by surprise. So like everyone else we're scrambling to figure out what a Trump administration will do. Among the many possibilities, the one that feels most certain is that the federal court system will tilt to the right. Generally speaking, this is usually good news for insurance companies.

From an insurance perspective, U.S. courts have tilted more toward the defendant for decades. **Presidents Reagan**, **Bush**, **Clinton** and **Bush** brought 28 years of relatively conservative or moderate judicial appointees.

> ***Liberal judges now on the bench are unlikely to retire in the next four years, hoping the Republican reign is short-lived.***

Despite fears, **President Obama** has not made a significant shift in this regard, naming federal judges who are, in our view, more inclined toward gradualism and the technical aspects of the law than activism from the bench. Supreme Court Justices **Sonia Sotamayor** and **Elena Kagan**, for example, are clearly liberal-leaning judges who support a more active government and an evolving view of the Constitution, but so far they have not been the firebrands many on the Left wished them to be. The same can be said of President Obama, who some conservatives paint as a socialist, but whose programs have deeply disappointed real socialists.

The nature of Obama's court appointments is also the result of Republican pressure: They have simply refused to accept his more liberal appointees, forcing Obama to nominate centrists. In the case of the Supreme Court, Republicans' refusal to even consider his moderately liberal nominee **Merrick Garland** to succeed the late **Antonin Scalia** has left a crucial seat open for a conservative Trump appointment.

Throughout her career Hillary Clinton has been more politically centrist than left, similar to her husband. But we are certain that if she had been elected president, the Democratic Party's progressive wing would have pushed her hard to make more liberal judicial appointments, especially on the Supreme Court. At 67, **Massachusetts** Sen. **Elizabeth Warren** was not a likely candidate, but Clinton would have faced pressure to nominate someone in her activist mold. There was also talk, though we thought it a long shot, that she'd nominate President Obama.

Trump was never considered a particularly conservative person before his race for the presidency, but he has pledged to appoint a true conservative to the court, and we suspect this is one promise he is sure to keep.

One dynamic we expect: liberal federal judges are almost certain to stay on the bench as long as possible now, hoping that in four years someone else will sit in the Oval Office. Supreme Court Justice **Ruth Bader Ginsberg**, leader of the court's liberal wing, will not give up her job under President Trump if she has to work while on life support.

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Growing Confidence Is Ending The Reluctance to Sell Homeowners

Starting two decades ago many insurers lost interest in homeowners insurance as the memory of Hurricanes Hugo (1988), Andrew (1992) and Iniki (1992) had reset the risk. The timidity was necessary, as the product was poorly underwritten, and prices were far too low to reflect the newly understood risk.

Twenty years on, underwriting is profoundly better. For decades, insurers were more than willing to lose customers in order to raise prices and tighten underwriting. This across-the-board aggressiveness was essential to returning the product line to health.

In November 2015, we told conference at-

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tendees that during extensive travels and conversations, we encountered few CEOs who expressed a desire for more homeowners insurance business. Intellectually, they accepted the improved performance of the business, but they were still not sure they wanted to pursue more homeowners insurance risk.

Clearly, we misread the market a year ago, because in the months since many insurers have been working hard to attract more property insurance customers of all types. This may be a foolish response to a lack of big **Florida** hurricanes or West Coast earthquakes, but we don't think so. There have been more than enough big weather events, such as hurricanes Sandy and Matthew, to keep everyone honest. It is much more likely that insurers feel more confident in their ability to select the right risks, to price them properly, and to be certain that they have a solid spread of geographic risk.

As a result, more significant competition for customers has already begun and seems poised to grow. Fear of catastrophe risk remains, which is very healthy. For the most part we see no irresponsibility by insurers, who are being as careful as the current tools and knowledge allow. We remain skeptical of the Florida market, which has a new structure that has yet to be fully stress-tested. But otherwise reason appears to prevail.

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Homeowners Insurance Advertising Rising, But a Boom Is Hard to See

For the past year or two we have noticed significant growth in advertising efforts focused directly on homeowners insurance, a clear sign of increasing competition. But we do not see a dramatic expansion of these efforts, certainly not approaching the advertising in auto insurance, because of the unique nature of homeowners risks.

Auto insurance is a far easier product to sell. Almost every insurer will gladly offer a policy to almost every driver. And those drivers who are most likely to be denied coverage are fully aware of their problems due to multiple accidents or traffic violations. This kind of broad approach is a perfect match for big media advertising campaigns, including advertising on billboards and television.

In homeowners insurance, properties that may seem perfectly insurable may be out of bounds for underwriters because of risks not perceived by the property owner, or because of a need to avoid geographic risk concentration. Thus, customers might respond to advertising, call the insurer, be rejected and be furious. A dollar of big-media advertising will yield far fewer useful prospects for property insurance than for auto insurance. This lower yield makes it less efficient to push marketing dollars to big, broad-media campaigns.

> ***Advertising for homeowners and renters insurance is strong, but they will never match auto insurance for big media buys.***

Look for homeowners insurers to continue investing instead in more targeted efforts, such as online marketing, that don't make for a high public profile, but will be a more effective use of advertising dollars.

Renters insurance is a different proposition altogether. There are no significant underwriting issues, and there is broad geographic need. The barrier to television, billboards and newspaper advertising (yes, there are still newspaper advertisements, just not many) is not underwriting, but rather return on investment. At an average premium of $188 a year, renters insurance just isn't lucrative enough to warrant 30 seconds on the Super Bowl.

Instead, the advertising boom in renters insurance is taking place online. Big, entrenched insurers are already pushing hard online, and a number of specialized brokers and insurers are

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forming specifically to market renters online.

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Renters Insurance Must Be a Key Focus

Renters insurance is an afterthought, a blip, an annoying side-bet, because with average premiums holding steady at around $188, there's just not enough there. But as we have discussed numerous times, renters insurance has become an important entry point for insurers to emerging households. There is also hope that policy sizes and premium will grow as new innovations expand coverage.

True, if you double the $2 billion renters insurance business, you get just $4 billion. Homeowners is 20 times larger. But at 12 million exposures and growing fast, renters is critical to customer attraction and retention. Insurers must be there, and must have their brand involved, if they want to successfully capture the customer of the future.

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International Capital Standards Are Now Up in the Air

At last year's conference and in the Dec. 14 issue of *Property Insurance Report*, we warned that evolving international capital standards could grind to a conclusion without sufficient input from U.S. property and casualty insurers. As a consequence, insurers could find their operations hampered by rules that are a mismatch to their operations, without enhancing the financial security of policyholders.

Enter a new federal government in the United States that is showing little interest for international anything. It is entirely possible that U.S. cooperation will be reduced or withdrawn from the talks, and even if the U.S. doesn't walk away, acceptance of any conclusion is not certain.

Two wild cards: Will anyone care? This is not the kind of issue that is likely to rise into active consideration by the new administration, which is going to have its hands full.

And there is also a chance that the talks will continue apace and banking interests will take precedence, with property and casualty insurers getting left at the curb.

Regardless of the outcome, our recommendation from a year ago stands: the issue of international capital standards, which seems to be off everyone's radar, deserves to be watched much more closely.

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The Federal Insurance Office, Already Marginal, May Be Buried in Indifference

The Republican-controlled government is already talking about "dismantling" the Dodd-Frank financial regulation law, which created the **Federal Insurance Office** (FIO).

We doubt that Dodd-Frank will be eliminated altogether, but something as marginally effective as the FIO, with no active supporters, is a likely early victim, either through an overt act of dismantling, or a soft destruction, by starving it of resources or a mandate. This is tied somewhat to the international capital discussion, which has been the biggest use case for FIO. Further, moving regulation from the states to the federal government is now a certain non-starter. PIR